January 7, 2004

India
Fiscal Decentralization to Rural Governments

January 7, 2004

Rural Development Unit
South Asia Region
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April 1 – March 31

**ACRONYMS**

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Fiscal Decentralization to Rural Governments
VOLUME I—Main Report

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1 Fiscal Decentralization to Rural Governments is a four volume study; Volume I—Main Report (Volume in hand); Volume II—Technical Analysis; Volume III—Karnataka Case Study; Volume IV—Kerala Case Study. Volumes II, III, and IV are available upon request.
Acknowledgments

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Fiscal Decentralization to Rural Governments

I. INTRODUCTION

1. The Government of India after several decades of deliberation introduced two Constitutional Amendments - the 73rd (rural decentralization) and 74th Amendments (urban decentralization) - to give effect to its objectives of decentralization. The 73rd Constitutional Amendment established mandatory provisions for decentralization to local governments in rural India. To understand the new institutional landscape and its impact on development, the Bank, in agreement with the Government of India and certain state governments, prepared a phased approach for providing policy assistance on rural decentralization in June 2000. It would (i) start with a broad overview of rural decentralization in India which has now been completed; (ii) investigate the status of fiscal decentralization to rural local governments which is the focus of this study; and (iii) finally, analyze the institutional framework for rural service delivery in priority sectors. These would be complemented by parallel studies and knowledge dissemination in specific areas. At the same time the Bank would begin exploring possibilities for lending, taking into account the reality, opportunities and needs of local governments in rural India. Hence, the work program was designed in three phases:

- **Phase 1: The Overview of Rural Decentralization in India (FY00-FY01, completed).** The objective was to increase the Bank’s understanding of what is happening. The output was an “Overview of Rural Decentralization in India” giving a broad perspective of the key issues. Because this was an internal report, the study and specific results received only limited dissemination.

- **Phase 2: Cross-sectoral issues (FY01-FY04, ongoing).** The objective is to selectively assist states in improving the design and monitoring of decentralization as well as developing a decentralization strategy. The approach is to highlight the mismatch between policy objectives and current practice and make recommendations on the way forward. The outputs would be: (i) Fiscal Decentralization Study (study at hand), (ii) Impacts of Decentralization Study (ongoing), (iii) Roles of Local Organizations Study (ongoing), (iv) Municipal Finances and Accountability (ongoing), and (iv) State Decentralization Discussions (Karnataka Decentralization Forum [May 2001], Kerala Decentralization Forum [September 2001], Workshop on Fiscal Decentralization to Local Governments [December 2002]; Workshop on Roles of Associations of Local Governments [June 2003]).

- **Phase 3: Rural Service Delivery (FY04-FY05).** The main objective would be to evaluate service delivery from a sectoral perspective, in particular for those sectors characterized by externalities and meritorious goods (for example, water and sanitation, health, education, natural resources, judiciary) and propose improvements that are consistent with the decentralization policies.
II. OBJECTIVE OF THE STUDY

2. The objective of this study is to review panchayat finances, identify issues and make recommendations to improve the fiscal decentralization system. Using Karnataka and Kerala as case studies, this report describes the context for rural decentralization in India, summarizes the current fiscal situation of district, block and village panchayats, identifies the main problems arising from the current practice, and outlines a set of reform options that might better satisfy the objectives of the central and state governments. Karnataka and Kerala were examined because these two states are generally thought to be more advanced than others in implementing rural fiscal decentralization and are therefore relevant for drawing lessons for the rest of India.

3. The study is presented in four volumes. The volume at hand (Volume I) is the Main Report. Volume II summarizes and compares the status of fiscal decentralization in Karnataka and Kerala and is intended for policy makers both at the central level and in other states. Volumes III and IV are the more detailed case studies of Karnataka and Kerala respectively, and are more relevant to policy makers in these states. This main report identifies problems associated with the current system of devolution and recommends ways to improve it to meet the objectives of the decentralization program. The next section encapsulates the key messages of the study.

III. SUMMARY

4. Inter-governmental relations are mostly hierarchical. There is a hierarchical arrangement of center-state-local governance. The 73rd Amendment to the Constitution made India one of the most politically decentralized countries in the developing world. By the Constitution and in practice, local government has an urban and a rural stream. Rural local governments are divided into three levels: district (zilla), block (taluk), and village (gram) panchayats. The design and implementation of the decentralization program are a state government responsibility. However implementation of key aspects of the program is lagging. Districts and blocks have no taxing powers and little expenditure autonomy. Both in Karnataka and Kerala, they more or less function as spending agents of higher-level governments. Gram panchayats are closest to the people, have some independent taxing power, and some discretion in expenditure decisions. Hence they are the primary subjects of this study.

5. Karnataka, with a population of 52 million people, has 5,870 rural local governments with 27 zilla parishads (districts), 175 block panchayats, and 5,659 Gram panchayats. The average gram panchayat in Karnataka has a population of 5,000. The total number of elected politicians in rural governments is 84,886. Of these, 44 percent are women, more than the 33 percent mandated by the Constitution in the reservation system. Since the 73rd Amendment, there have been two local elections and two State Finance Commissions (SFCs). Panchayats in Karnataka have been nominally assigned all the 29 expenditure subjects prescribed in the Constitutional Amendment, including rural drinking water, primary and secondary education, primary health, as well as assigned funds and functionaries (state employees at the panchayat level). About 30 percent of state public expenditures are channeled through panchayats.

6. Kerala has 31 million people represented in 1,157 local governments, of which 53 are municipalities, 14 zilla panchayats (ZP), 152 block and 991 gram panchayats. The average gram panchayat in Kerala has a population of 25,000. The total number of elected rural politicians is 12,117. Kerala comes closer to having effectively devolved funds, functions and functionaries. Of the 29 expenditure subjects assigned to panchayats, Kerala has devolved functionaries and funds for 15 of these functions. About 18 percent of state expenditures (and 30 percent of plan expenditures) are channeled through panchayats.

7. The stories of Karnataka and Kerala illustrate the variety of challenges that India faces in implementing decentralization and achieving its benefits in terms of improved delivery of services to rural communities. The two states came to their current stage of the decentralization process from
different directions. Karnataka has had a long history of initiatives in support of decentralization, beginning in the 19th century, while Kerala came belatedly to its support. What distinguishes Kerala from the other states in India is the “big-bang” approach it has taken. The strategy was to implement a significant fiscal decentralization program and to “learn by doing”. As a result Kerala has now developed a decentralized fiscal structure in terms of grant design and the empowerment of the gram panchayats. Karnataka’s is the more cautious approach where the state government still holds the balance of fiscal decision-making power. While there are important differences between the two states in some aspects of the systemic weaknesses observed, there are also similar flaws. Neither approach has achieved effective empowerment of local governments and neither appears to have substantially ratcheted up local government revenue raising, although the Kerala model is more developed. Both states have weak, outdated and poorly functioning financial management systems that debilitating the policy making and planning process, as well as the management and accountability of the decentralized system. In the absence of reliable information on the revenues and expenditures of local bodies, neither the states nor the center can lead a reasonable fiscal decentralization program. This also raises questions regarding the validity of central and state finance commission recommendations.

8. Perhaps the main weakness in Karnataka’s experience has been its limited devolution of meaningful authority and capacity to local decision makers, while Kerala’s disappointments are traceable to the strain on state finances in the years after the implementation of its decentralization program. The consequences of these weaknesses have been similar despite their different origins. Local governments have had relatively few resources and relatively little discretion with which to make a significant impact on service delivery. Perhaps as a result, local communities have not engaged fully with the processes of planning and accountability to the extent hoped for by policy makers.

9. An important lesson learned in these case studies is that one necessary condition for a well-functioning system of fiscal decentralization is a healthy state financial position. Because the Constitutional Amendment defined decentralization to be a state subject, until state governments can improve their deficit position, local governments can expect continued underfunding of their present grant entitlements, resistance to new program development, and hesitation to assign more own source revenues to local governments. Before India can fix the fiscal position of its local governments (rural and urban), it must fix the fiscal problems of its state governments². This study is limited to a review of the fiscal relations between the state and local governments and thus does not comment on solutions to state finance problems.

10. International experience offers some practical lessons for the design and implementation of a system of inter-governmental fiscal relations. As decentralization is often pursued with different objectives in mind and is a highly political process that needs to reflect the particular circumstances of a country, there is no single ‘best’ system. However, there is a set of 11 general principles that many analysts believe are necessary for a fiscal decentralization system to work. These are summarized in Box 1 below.

² For example in Karnataka, as a result of fiscal compression, expenditure decentralization has been declining during the last decade. See Volume III for more details.
Box 1: Practical Principles from International Experience for Fiscal Decentralization

1. All of the key components of a decentralized fiscal system need to be addressed: significant expenditure responsibility and discretion, independent revenue raising powers, elected local council, and local officers and employees who are accountable to the elected local council.

2. Finance follows function—first should come the assignment of expenditure responsibility to local governments and then the assignment of revenue responsibility should be determined.

3. There must be a strong state ability to monitor and evaluate the intergovernmental fiscal system.

4. One intergovernmental system does not fit the urban and the rural sector—these governments have very different capabilities to deliver and finance services, and certainly different capabilities to borrow. These differences need to be recognized, that is, where different local governments are given different financing powers and expenditure responsibilities.

5. The assignment of revenue powers to local governments should link revenue and expenditure decisions at the margin.

6. Higher-level governments must follow the rules of the intergovernmental fiscal system that they themselves create. But the higher-level government does not always keep the rules that it makes. For example the imposition of unfunded expenditure mandates on local governments, the under funding of transfer programs and so on.

7. The intergovernmental fiscal system should be kept simple.

8. Intergovernmental transfers should be designed to match a set of clearly specified objectives.

9. The intergovernmental fiscal system should be built on policies that consider impacts on all levels of government—central, state and local.

10. A hard budget constraint should be imposed on local governments.

11. The intergovernmental fiscal system should be flexible to accommodate changes.


11. The first phase of the program of reforms recommended by the study for Karnataka and Kerala would require substantial efforts and commitment. Step one is the development by the states of a blueprint for their system of fiscal decentralization. Step two is to recognize that correcting the current problems and moving decentralization closer to the Government of India's (and the states') objectives requires addressing a number of detailed issues. In Karnataka, it is necessary to revisit the detailed assignment of functions, the fiscal transfer system and the administrative arrangement for supporting decentralization, and capacity building at the state and local level. In Kerala, it is necessary to fix the financial management system, to address the issue of the administrative arrangements and also to build the capacity to support decentralization. For both this phase also envisages a package of measures to revise and update the financial management systems. Both states have problems with the productivity of their local revenue systems, and particularly with the property tax. Finally, although Kerala has put into place appropriate downward accountability measures, many are not working properly because of design, problems of execution, or because the potential impact of local government program expenditures is inadequate to provide incentives to engage. In summary:

- First, expenditure assignments need to be clarified between the different tiers of the government. The expenditure assignments should be set out by the state, spelled out in some detail at the level of sub-functions and should largely replace the ‘concurrent’ approach that is now in place.

- Second, decentralization should result in local governments having autonomy and sufficient
resources to provide meaningful services to their communities. Earmarked transfers (schemes) designed by higher levels of government cannot dominate local government finances in a successful fiscal decentralization program. Under the present arrangement, panchayats make no contribution to the design of the schemes and are given little discretion in implementation. They also have limited autonomy over their staff. It is important to begin developing these capacities at the local government level to effectively deliver local public goods.

- Third, panchayat resources need to be augmented through increased discretionary funds. There are at least two possible options- (i) consolidate some of the schemes into untied funds for GPs; and (ii) improve the property tax system in the states.

- Fourth, the transfer system needs to be redesigned by making it transparent through a formula driven allocation. The critical element of reform is to unbundle the transfer system from scheme based transfers into broad programs and impart flexibility and autonomy to local governments to make allocations according to their priorities.

- Fifth, an appropriate and properly functioning financial management system is necessary to provide meaningful information to policy makers and systems managers who need to steer decentralization on an ongoing basis. An important contribution of this study emerged from perhaps the primary difficulty encountered during its execution. The initial intent of this work was to rely on data made available by the State Finance Commissions. However, initial tests on this data demonstrated that the fiscal information system in the two states does not provide an adequate base for designing, implementing and evaluating the decentralization policy. The development of a proper fiscal information system is an important recommendation of this study.

- Sixth, downward accountability depends not only on the design and effective execution of appropriate mechanisms for informing and involving communities in decision-making and performance oversight; but it also depends on local governments having enough money and enough expenditure responsibility to attract and hold the interest of the community.

- Seventh, rural local government finance in India is part of an intergovernmental system that includes the fiscal relations between the center and the states, the finances of state governments, and the finances of the urban governments within the state. The system must be designed as a whole if it is to succeed. In particular, an issue in India is that the fiscal health and development of local government finances is very much dependent on the fiscal health of the state governments.

IV. ISSUES IN THE CURRENT SYSTEM

12. The systems of intergovernmental transfers in the two states are different. In Karnataka, the total expenditure of rural local governments is equivalent to about 20 percent of the total state expenditure, with 20 percent spent at Zilla Panchayats (ZP), 18 percent at Taluk Panchayats (TP) and 62 percent at Gram Panchayats (GP). Eighty percent of the budget of the local governments is through a complicated system of 428 state and central government conditional grants to rural bodies. The conditions on these schemes are stringent enough to leave these local governments with little expenditure discretion. The Gram Panchayats receive only eight of these schemes (grants), which, together, finance about 80 percent of GP expenditures. In Kerala, on the other hand, 18 percent of the state expenditures take place at the local government level with 22 percent spent at ZP level, 18 percent at TP level and 66 percent at GP level. About 80 percent of grants are for plan purposes and are allocated as general-purpose grants. Thus while both states would appear to have devolved similar shares of public expenditures to the third tier, Kerala has devolved more discretion. The decentralized planning process in Kerala has a built-in mechanism for bottom-up planning for the use of these funds. It seems clear that Kerala has decided that
the *gram panchayat* will be the principal unit of local self-government. There appears to be more ambivalence about this in Karnataka, where the *gram panchayats* are the only units of rural local government with independent taxing powers, but account for only about 6 percent of total rural local government spending.

13. **In both states the fiscal framework for rural local government finance has flaws, but the shortcomings in the two states are different.** One might expect that the goals the government wants to achieve with fiscal decentralization are better local public services, increased revenue mobilization, a more efficient use of public monies, and more involvement of people in the process of their governance. There are several reasons why the present system falls short of meeting these goals. The case studies of Kerala and Karnataka point to several problem areas, including expenditure assignments, local autonomy over budgets, fiscal role of the *Gram panchayats*, the transfer system, fiscal pressures and revenue efforts by *gram panchayats*\(^3\). These are discussed below.

**Expenditure Assignment**

14. **In Karnataka the assignment of expenditure responsibilities is not clear.** Karnataka has nominally assigned all 29 subjects to panchayats. But perhaps because some of these functions were thought to have important externalities, or perhaps because state politicians and bureaucrats were unwilling to relinquish power, Karnataka has retained the responsibility for a large number of key decisions regarding these services and left local governments with limited discretion. Further, relatively little has been done to unbundle the general subjects prescribed in the Constitution, and make expenditure assignments at a more detailed level of activity and sub-activity. As a result, there is an unclear assignment of expenditures between the three tiers that has led to duplication of efforts, some failure to assume leadership in the delivery of services, coordination problems and some uncertainty on the part of the local population as to where accountability lies.

15. **In Kerala expenditure assignments are much clearer.** Assignments took place at the level of "activities" and complementary legislation was issued to change the role of key line agencies. Functions have been divided according to the various tiers and in most cases broken into activities to avoid overlapping. Responsibilities are therefore clearer. *Gram panchayat* functions are broken into: (i) three mandatory functions with 27 items, (ii) general functions with 14 items, and (iii) 19 sectoral functions subdivided into 74 items (see Volume IV). This clarity of assignments made the state government more accountable in its implementation of decentralization, which has been progressing since 1995. The change in expenditure patterns for functions allocated to GPs is illustrated in Figure 1. In 1995 only 32 percent of the expenditures for functions assigned to *gram panchayats* took place at the discretion of the *Gram Panchayat*. Over a five-year period, this allocation has changed whereas the *gram panchayat* now has control over 68 percent of the expenditures.

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\(^3\) Details in Volume III for Karnataka and Volume IV for Kerala.
Figure 1: Control over expenditures by gram panchayats for functions devolved to them is increasing in Kerala (case study on Tholicode gram panchayat)

Local Autonomy

16. One major constraint to true fiscal decentralization is the limited expenditure discretion that has been given to the local governments, though the situation varies in both the states. In Karnataka, there is almost no discretion in the expenditure of plan funds. Almost 50 percent are earmarked for salaries, 20 percent for transfers to individuals, and most of the remainder for input purchases where there is little local discretion. The situation is similar for non-plan funds (89 percent for salaries and transfers). Rao, and others, 2003, in Volume III, estimate that in Karnataka, even though a significant portion of public expenditures are being channeled through panchayats, in effect expenditures actually controlled by local governments are well less than 10 percent of total rural spending by local bodies. The lack of independent sources of revenue and total dependence of ZPs and TPs on transfers makes the entire fiscal decentralization process for these levels hostage to the transfer system. There are almost no general purpose transfers at the district and block levels. The scheme-based devolution and micro allocation of resources even within the schemes do not provide any leeway to the districts and taluks in making allocation decisions according to their priorities. In fact, the entire fiscal decentralization process has ensured that the district and block panchayats are mere disbursing agents of the higher level governments. However, gram panchayats, because they have own source revenues, and because they receive their transfers more in the form of unconditional transfers, do have more discretion to allocate expenditures to meet local needs. It is estimated that they have complete authority to allocate
about one-third of their budgets, and limited control over expenditures of another one-third. In Kerala, Gram panchayats have more expenditure discretion because grant funds tend to be unconditional, and there is more locally raised revenue. However, in both states, the higher-level governments retained most powers to hire, fire and compensate local government employees, hence Panchayat Raj Institutions (PRIs) have relatively little control over their personnel budgets. In Kerala, there is some administrative autonomy. For professionals such as doctors, engineers, agricultural officers, and so on, there is a sort of dual control with line departments exercising limited control over local employees. Although the state government determines compensation, the panchayat committee does have some powers to initiate disciplinary action.

**Fiscal Role of Gram Panchayats.**

17. The fiscal role of Gram Panchayats in Karnataka is negligible and in Kerala, small. The role of the Gram panchayats in rural local finance is quite small. Yet, the gram panchayat is arguably the best choice for local autonomy given that this tier of government is closest to the people and the fact that it has some taxing power. The analysis for Karnataka (1998 data) shows that the level of expenditures incurred at the GP level is extremely low both in per capita terms (Rs. 68) and as a percent of gross domestic product (0.38 percent). Even as a ratio of total expenditure of rural local governments, the role of GPs is quite limited (6 percent of total expenditures). In addition, overwhelming proportions of expenditures are incurred for specific purposes such as JGSY\(^4\), welfare of scheduled castes, and salaries. Of course, these are necessary, but it is worth noting that they are directed to benefit a small section of the population within the GPs. The activities of GPs do not evolve appreciable interest and response from the majority of people. Many have commented on the apparent lack of local interest in the business of the panchayats as evidenced by the poor attendance at the gram sabhas\(^5\). The level of GP spending is significantly higher in Kerala. In 1999, the average GP spent Rs. 328, and total spending by GPs was equivalent to about 1.4 percent of state domestic product. As a share of total state government spending, gram panchayat expenditures rose from 4 percent in 1994 to 8 percent in 1999.

**Revenue Efforts**

18. Revenue effort by Gram Panchayats is weak in both states. Kerala and Karnataka have given the gram panchayats independent revenue raising power, but in neither state has it been effectively used. Thus overall, in both states, own source revenues are negligible—less than one percent of Gross State Domestic Product from their own sources\(^6\). Local revenues as percentage of total revenues are small by international standards (Figure 2). A number of reasons have been suggested for this weak revenue performance:

- An unwillingness of the local officials to enforce the tax laws.
- The limited capacity of local government officials to effectively administer a revenue system.
- Weak administration procedures, for example, tax rolls are not maintained, assessments are not done in a scientific way and are not updated, and collection procedures are not efficient.
- The property tax base is not defined in a way to be amenable to capturing the increase in property values for purposes of taxation.
- The need for more productive bases to tax.

\(^4\) An employment generation scheme through labor intensive infrastructure.

\(^5\) Village meetings for all voting population. Holding of these meetings is mandatory as per the State Acts.

\(^6\) The ratio of own source revenue to State Domestic Product is 0.1 percent in Kerala, and 0.08 in Karnataka.
• Taxpayers see little benefit from paying taxes to local governments.

• Local officials have little incentive to raise additional taxes, that is, face little penalty if they do not, and little reward if they do. Relatively few of the Gram panchayats have opted to levy the highest property tax rate allowed.

Figure 2: Local Revenues as a Percentage of Total Revenues for Selected Countries (1999)


19. Collection rates on local taxes in Karnataka are very low. The estimated average amount of own source revenues for GPs was Rs. 16 per capita and only 0.08 percentage of GDDP in 2001. That even this small amount accounted for more than 20 percent of total revenues reinforces the point made above that the overall role of the GP in providing public services is negligible. Collection rates on the property tax are very low. On average, per capita collections were only Rs. 8 in 2001, and showed a decline from the previous year. Almost 80 percent of GPs in the four sample districts that were studied in detail had property collections less than Rs. 10. The collection rate, on average, was less than 70 percent of the demand in 2000-01. In many GPs, the level of collections is so low that the viability of the property tax is in question.

20. Accessibility to markets and public perception of service delivery are important determinants of revenues. There are lessons to be learned from the variation in per capita property tax revenues and per capita total own source revenues across GPs. Why do some Gram panchayats collect more than others? Per capita own revenues and per capita revenue from property taxes were regressed on a number of variables representing revenue capacity and the demand for services in the GPs in the four sample districts in Karnataka. These equations bring about some interesting insights. There seems to be no relationship between per capita revenues (including per capita property tax) and the level of development in a GP7. This is not surprising in a system where the property tax is levied as a lump sum tax on housing units. The lack of relationship between per capita own source revenues and the proxies of agricultural incomes is surprising. Interestingly, per capita property taxes and per capita own revenues are significantly and positively related to the variables representing accessibility to markets - the road length per square kilometer area and proportion of metalled roads. We also find that total own source revenues...

7 For more details refer to Volume III—Karnataka Case Study.
tend to be higher in GPs that are closer to a district or block headquarters, primarily because non-property tax revenues (fee and charges) are higher. The absence of a relationship with the property tax again points out the inability of the property tax system to take advantage of the higher values of property in GPs proximate to major towns and cities. The findings about public perception of service delivery are also interesting. For example, the availability of water supply in a GP does not tend to be associated with increased revenues for that GP.

21. In Kerala own revenues have been increasing even with larger transfers (Figure 3). In Kerala, there are some parallels with the Karnataka experience, but also some significant differences. In 1999, own source revenues accounted for about 18 percent of total GP revenues, down from 31 percent in 1994. The decline was a result of the increase in state transfers and not due to a decline in local own source revenues. In fact, the level of per capita own source revenues increased from Rs. 24 in 1994 to Rs. 57 in 1999 (Rs. 33 in real terms). Therefore, while the level of collections is still weak, it is well above the average level of Karnataka, and there has been some growth. Within own source revenues, non tax revenues, however, have been much more buoyant than tax revenues. Per capita amounts have increased from Rs. 7 in 1994 to Rs. 29 in 1999. The tax base does not appear to have responded to a booming construction sector in the state. Nor do they reflect the relatively large inflow of foreign remittances. This is likely due to a failure of the valuation system to capture increases in property values. There is also evidence that panchayats may be unwilling to push aggressively for higher property taxes: of 50 GPs sampled for detailed analysis, only three have chosen to use the maximum tax rate permitted by the statutes and 23 have chosen the minimum rate. It is estimated that only about 40 percent of the revenue potential has been captured.
Figure 3: Growth in Per Capita Own Source Revenues and State Plan Grants (Transfers) in Kerala

Source: Data collected for the study, 2003. (Details in Volume IV).

22. There are wide variations in per capita own source revenues among GPs in Kerala, and much can be learned from understanding the determinants of these variations. Per capita taxes range from Rs. 4 to Rs. 327 around a mean of Rs. 27, and per capita non taxes from Rs. 9 to Rs. 586 around a

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8 One might ask why the local revenue system has performed so much more poorly than the state system. There are a number of answers to this. First, the state has access to broad based taxes on income and consumption whereas the local governments may tax only property and levy user charges. The built-in growth for these local taxes is less strong, and require discretionary adjustments (e.g., revaluation or changes in user prices) to realize the increase. Second the growth in the tax base is largely in the urban rather than the rural areas. The growth in rural economies is usually located in sectors where tax assessment and collection is most difficult. The problem is compounded by the weaker tax administration skills at the rural local government level, and the inherently greater difficulty that local officials have with collected from the local population. Finally, rural local governments in India have a difficult time showing local voters what their money buys.
mean of Rs. 57. Using a multiple regression analysis, the Kerala study is able to explain about 25 percent of the variation among the 615 Gram panchayats for which data is available. In general, per capita own source revenues are significantly higher in GPs where the level of economic activity is stronger, where population is larger, and where there is a smaller land area. The percent of SC-ST population is not a significant determinant. We find evidence of "district effects", that is, after all else is accounted for, GPs in some districts raise significantly more than GPs in other districts. This suggests the possibility of revenue effort being related to local cultural or leadership factors.

The Transfer system

23. In Karnataka the transfer system is complicated, non-transparent, and non-equalizing. There are 428 schemes (conditional grants) to rural local governments from the state and the center, and it is difficult to coordinate these or monitor their effectiveness. Because the conditions on the expenditure of these grant funds are so restrictive, local governments have little opportunity to structure local expenditure to match local preferences. A small portion of the total grant funds is given to Gram panchayats as untied aid, and this does provide some measure of local discretion. However, the distribution of untied grants among GPs is done on a basis of equal amounts per GP. There is no evidence of equalization in the distribution of these grants, in fact, even the poverty alleviation grants do not go more heavily to panchayats with a greater concentration of poor families. It would not be far off the mark to say that the present system of intergovernmental transfers in Karnataka is inconsistent with the goal of developing fiscal decentralization in the rural local government sector.

24. The transfer system in Kerala is less complicated and more equalizing. In the Kerala system, the Gram Panchayats do receive grants through sponsored schemes where the local bodies act as agents of the central and state governments. Plan grants and the sponsored schemes together form about 35-40 percent of the state plan. For the sponsored schemes broad guidelines are issued by the sponsoring government or department. Even so, the panchayat decides the location of the project and selects the beneficiaries, besides taking up the responsibility for the implementation of the project. But the most notable feature of Kerala's fiscal decentralization is the large share of untied grants, over 80 percent in 1998-99, in the structure of transfers to gram panchayats. Both in percentage and per capita terms this represents a level that is probably unique in all of India. The Kerala government grants to local bodies consist of non-plan and plan categories. Non-plan grants are broadly divided into statutory and non-statutory grants. Statutory grants are the largest of these two components and consist of assigned taxes and vehicle tax compensation. The assigned tax consists of a basic tax on land and a surcharge (4 percent) on stamp duty collected under the provisions of the Kerala Stamp Act, 1959, on the value of the property transacted. The entire amount is meant to be transferred to panchayats after deducting collection charges. Besides these taxes, 20 percent of the Motor Vehicles Tax's net collection, also called Vehicle Tax Compensation (VTC), is to be distributed to GPs on the basis of the length and types of roads in a panchayat. Statutory grants accounted for about 13 percent of all transfers to GPs in 1999, and there is local government discretion as to the expenditure of these funds. Plan grants are the most important and were the preferred instrument to devolve more resources to panchayats in the "big-bang" decentralization. The per capita state plan grant has increased from Rs. 12 in 1993-94 to Rs. 207 in 1998-99, an increase of about 15 times in a period of six years. This corresponds to an increase from 3 percent to about 12 percent of state revenue. This increase is probably overestimated though since panchayats have only been receiving a share of their entitlements. Overall, the distribution of transfers among Gram panchayats in Kerala would appear to be somewhat horizontally equalizing. This is largely due to plan grants, which appear to be objectively distributed, and to favor those GPs with larger shares of SC-ST population, and to discriminate against those GPs with larger populations and those having a greater share of better constructed housing. Essentially the same pattern is found for central government grants.

9 For more details, refer to Volume III—Karnataka Case Study.
10 See Volume II, Chapter III, Section F.
25. **However horizontal disparities are widening.** In both states, there are wide variations in per capita expenditures. In Karnataka, this disparity is not only between different districts but within each of the districts analyzed. In general, per capita expenditure of GPs is highest in the more affluent districts though on average, 37 percent of the GPs had per capita expenditures of less than Rs. 20. *Gram Panchayats* with a greater proportion of scheduled castes and tribes spend significantly more, cet. par., and intergovernmental transfers have a greater impact on expenditures than do revenues raised from own sources. The story is similar in Kerala, where there are also significant and growing disparities across *gram panchayats*. Statistical analysis of this variation suggests that per capita expenditures tend to be higher in *gram panchayats* with smaller populations, larger land areas and greater concentrations of SCST population. It is the distribution of plan expenditures, which are grant funded, that brings some degree of equalization to this overall expenditure pattern.

**Fiscal Pressures on Gram Panchayat**

26. **The fiscal pressures on GPs are growing.** This is especially true in Kerala where the *gram panchayats* play a more significant budgetary role. The volume of expenditures the *panchayats* incur or manage keeps expanding. As functional devolution expands, with several institutions already transferred to GPs and with many *panchayats* forced to take several “agency” functions on behalf of the state and central governments, their expenditure responsibilities have increased. The Kerala analysis examined finances of a representative sample of 26 *gram panchayats* for which detailed revenue and expenditure data were gathered. The fiscal balance in this exercise was measured as the difference between the sum of own source revenues, shared taxes, and assigned taxes and recurrent expenditures. The results of this calculation show that there is no *panchayat* that generated a surplus from own revenue (including assigned tax grants) consistently for the four years from 1999 to 2002 in the sample of 26 GPs.

**Local Government Accounting Systems**

27. **In both states, outdated local government accounting systems have been overwhelmed by the requirements of decentralization.** In both states, control mechanisms of the state government over financial management in the *panchayats* appear to be relaxed. The local government accounting system is in danger of collapse and annual audits have fallen in arrears. It is a cash-based accounting system. The registers and books of accounts are outdated and unable to account for the increased and diversified flow of resources of the present decentralized system. Moreover, there are no uniform accounting codes or rules for *panchayats*. GPs still rely on the old *Panchayat* accounting rules, while TPs and ZPs do not have designated accounting rules. As a result of this state of affairs, ongoing monitoring of financial management is difficult. It is not surprising under these circumstances that *panchayats* do not capture fully the extent of the financial resources they handle.

28. **In Karnataka, duplication and overlapping responsibilities confuse authority and accountability, as well as complicate delay reporting and reconciliation.** No one knows – or could know - cash balances on a day-to-day basis. A general ledger is not part of the system, making it difficult to reconcile receipts and payments from multiple sources. The multiplicity of accounts, accounting centers, accountants and reporting streams result in delays of several months in reporting, and limit oversight by authorized bodies. This is further complicated by the many budget items (40-50) through which transfers are made to PRIs. The *panchayat* accounts themselves are incomplete, in part because of the various ways in which payments of electricity bills are reflected.

29. **Some consequences of these accounting inadequacies are serious.** Budgeting seems to have been reduced to a compliance formality. There is little use of the budget for fiscal planning. There is no linkage between the annual plan and the budget, making monitoring and evaluation difficult. There is a lack of reliable information about the assets required to be maintained by the *panchayats*. It is difficult to determine unit costs of projects and various services like water supply, street lighting, sanitation, and so on. Also, the economic viability of proposed projects is unclear. State Finance Commissions have had to
assess the financial requirements of the PRIs by informed guesswork more than from data.

30. **Meanwhile, in Kerala, old systems are under stress and new ones have not yet emerged to take their place.** Since 1996-97, panchayat funds have tripled and the state government’s grants to Gram panchayats have increased ninefold. Despite this substantial increase in the flow of resources, financial management is still led by accounting rules that were framed more than 40 years ago. In addition, the state government has complicated the situation by issuing numerous regulations for the use of these funds. The result is a complicated accounting system, and one that is yet to be computerized.

31. **Consequences in Kerala of these inadequacies are also serious.** Although panchayats are required to prepare an annual statement of all receipts and expenditures, consolidation of accounts does not take place in any of the three tiers of rural local government. GPs prepare an Annual Financial Statement, but it does not include Plan funds or funds received for Centrally Sponsored Schemes. TPs and ZPs do not prepare an Annual Financial Statement. In the absence of consolidated accounts and financial statements, it is difficult even for the panchayat committee (not to mention the general public) to know the extent of receipts and expenditures as well as the financial position of the local body.

**Information System on Local Finances**

32. **Neither state has an adequate information system in place on local finances.** There is no adequate information system which can be used by local governments to plan their revenue and expenditure programs, or which can be used by higher-level governments to monitor the fiscal performance of local governments. The district and block governments in Karnataka do not all keep budgets and the data available for gram panchayats is incomparable at best and flawed at worst. A similar situation holds in Kerala. These issues of reliable information on finances and financial performance have important implications for planning at federal, state and local levels. As things stand at present, recommendations for fiscal reform may be made based on data that misrepresent the situation. Most important, assessment of the fiscal health of the local governments may be substantially incorrect, leading to misguided attempts at reform.

33. **A result of this problem is that the high closing balances posted by panchayats in “official data” are misleading in both states.** Local government data supposedly collected as part of the normal fiscal monitoring process and used by the Central Finance Commissions and the State Finance Commissions are erroneous. The data inflates the amount of resources at the disposal of panchayats, suggests a budget surplus, and may create temptations for fiscally strapped state governments to further reduce the already negligible funds at the disposal of gram panchayats. What seemed implausible to the research team is that cash-strapped states would allow this condition to continue for an extended period. The data does not tell a transparent story on local financial performance for three reasons. First, official records of panchayat revenues are based on budgeted allocations rather than funds received; second, the significant irregularity in the timing of transfers received by local governments distorts both actual expenditure patterns and the reporting of these expenditures; and, third, weaknesses in record keeping systems and practices are prevalent. As a result the local finance data reported to State and Central Finance Commissions shows large closing balances in panchayat accounts. If this were accurate it would imply that the panchayats were receiving considerably more revenue than they had the capacity to spend. In Karnataka and Kerala, these reported balances were equivalent to about 50 percent and 70 percent of annual revenues, respectively. Such a situation would question the efficacy of these local governments as development agencies. In fact these balances do not describe the real financial position.

34. **Some steps to improve accountability have been introduced.** Kerala is the only state in the country where full recognition has been given to the principle that the primary accountability of the local government institutions is downwards to the local community. Various innovative tools and methods introduced during the people’s plan campaign to make the panchayat accountable to the community have not yet been perfected. These include social audits, the creation of beneficiary committees, right to
information initiatives, citizen charters and an ombudsman. All of these initiatives have run into problems and are yet to mature.

V. RECOMMENDATIONS

35. The Constitutional Amendments of 1993 commit the Indian federalism to development of a third tier of government with some degree of fiscal autonomy. Though Kerala and Karnataka are two states that have been aggressive in promoting decentralization, both still face significant problems with their programs. The structure of the local government financing system would seem more in step with the objectives of decentralization in Kerala, but implementation has been a problem here as well. Karnataka, on the other hand, despite important strides on other aspects of decentralization, has not yet moved to a financing structure that is consistent with the goals of fiscal decentralization. Neither state has prepared a blueprint that can serve as a guideline for resolving such problems and for developing its rural local government financing policy. A state policy paper on fiscal decentralization goals, and an action plan for achieving these goals, should be prepared by each state. The following are some of the basic recommendations that would be considered for this paper.

A. Clarify Expenditure Assignments and Local Government Hierarchy

36. A first step towards developing a workable fiscal decentralization program for rural local governments is a clearly designed set of expenditure assignments. The expenditure assignments should be set by the state government, and should largely replace the “concurrent approach” that is now in place. The expenditure assignments should be spelled out in some detail at the level of sub-functions. Only then can there be a basis for deciding on the proper vertical sharing of state revenues among the districts, blocks, and village panchayats.

37. State governments might rethink the roles of the three tiers of rural local governments. International comparisons do not reveal a clean pattern as to the optimal structure of local governments. Some countries prefer a smaller number and larger size, such as Indonesia and South Africa, while others seem to favor a small population for the lowest unit, such as Ukraine, Switzerland and Sweden (Table 1). No clear patterns separate developed from developing countries either. However, three tiers of rural local governments below the state level with overlapping responsibilities as in India is costly, invites duplication of effort, and confuses the accountability objectives of the government’s decentralization program. For all practical purposes, districts and blocks are now spending agents of the central government with relatively little autonomy to shape the expenditure budget and no taxing powers to affect the overall size of the budget. Moreover, these units of rural local government are considerably larger in population size than the Gram Panchayats, hence they may be less suitable as the basic units of decentralization. Thought might be given to defining more clearly the role of the districts and blocks as either primarily deconcentrated arms of the state government, or as autonomous governments representing the preferences of their constituents. Several initiatives need to take place. First and foremost is to clarify lines of accountability of functionaries. Are these accountable to the elected councils or to the line agencies? And if they are accountable to line agencies, what is the role of elected members? Until these roles are clearly specified, district and block management will remain confused.
Table 1: Population of Lowest Government Tier in Selected Countries

<table>
<thead>
<tr>
<th>Country</th>
<th>Tiers of Government</th>
<th>Number of Lowest Tier Governments</th>
<th>Average Population of the Lowest Tier</th>
</tr>
</thead>
<tbody>
<tr>
<td>India</td>
<td>5</td>
<td>240,588</td>
<td>2,892</td>
</tr>
<tr>
<td>China</td>
<td>5</td>
<td>44,741</td>
<td>28,217</td>
</tr>
<tr>
<td>Indonesia</td>
<td>3</td>
<td>341</td>
<td>617,070</td>
</tr>
<tr>
<td>Mexico</td>
<td>3</td>
<td>2,428</td>
<td>40,348</td>
</tr>
<tr>
<td>Poland</td>
<td>4</td>
<td>2,489</td>
<td>15,528</td>
</tr>
<tr>
<td>Ukraine</td>
<td>5</td>
<td>28,651</td>
<td>1,728</td>
</tr>
<tr>
<td>South Africa</td>
<td>3</td>
<td>286</td>
<td>149,654</td>
</tr>
<tr>
<td>Australia</td>
<td>3</td>
<td>722</td>
<td>26,568</td>
</tr>
<tr>
<td>Sweden</td>
<td>3</td>
<td>14,561</td>
<td>5,642</td>
</tr>
<tr>
<td>Germany</td>
<td>3</td>
<td>286</td>
<td>31,010</td>
</tr>
<tr>
<td>Switzerland</td>
<td>3</td>
<td>2,903</td>
<td>2,473</td>
</tr>
<tr>
<td>Canada</td>
<td>3</td>
<td>936</td>
<td>32,853</td>
</tr>
<tr>
<td>Japan</td>
<td>3</td>
<td>3,229</td>
<td>39,291</td>
</tr>
</tbody>
</table>

Note: For India, only rural governments are included and statistics are not directly comparable with the other countries.

Source: Own calculations based on World Development Indicators for the population and various sources for each country.

38. **Priority should be given to empowering gram panchayats.** Because the gram panchayats are closest to the people, it can best detect and respond to people’s preferences and needs. The long term goal should be to endow them with sufficient autonomy and resources to respond to local needs. States should avoid devolving responsibilities to panchayats for schemes designed completely by a higher-level government, transferring to local government staff that they did not recruit and cannot fire, or asking them to spend their resources maintaining assets that they did not create. Gram panchayats should be allowed to spend public resources according to their priorities, to recruit, pay and fire their own staff, and to procure technical assistance, contractors and other services from the private, NGO or public sector as they see fit. Plans, budgets, funds and assets should be treated as theirs, and states and higher level panchayats should refrain from intervening in their affairs, other than for due diligence matters, such as audits, or to monitor their performance in shared programs, or to play a proper role in the case of service delivery in cases where significant externalities are present.

39. **However, state governments need to think carefully about the proposal to empower gram panchayats.** There are drawbacks to this proposal however. First, Gram panchayats have the weakest capacity to deliver services and raise taxes, in part because they are the smallest unit of local government. Care must be taken in the fiscal assignments to GPs. This problem may be more serious in Karnataka where the gram panchayats average only about 5,000 in population, versus Kerala where they average 25,000. Second, unless one of the higher panchayats assumes a coordinating role, service assignment would have to focus on expenditures whose benefits are local.
B. Strengthen Local Government Budgetary Autonomy

40. **Consolidate schemes in Karnataka.** Rural local governments in Karnataka are financed primarily by conditional grants or “schemes.” Responsibility for many central and state programs has been passed to local governments, but discretion over the use of these funds has been held by higher-level governments. There are over 400 such schemes now operating in Karnataka. Those schemes that match the expenditure responsibilities of the gram panchayats should be consolidated into a small number of general-purpose grants, and passed to the gram panchayats. All other schemes should be consolidated within each of the state departments so that there can be greater flexibility to prioritise spending decisions within the departments. This consolidation will serve several purposes: it will make the intergovernmental transfer system more transparent, it will allow a better match between expenditures for rural development and local preferences, and it will significantly augment the resources of the gram panchayats. In effect, this is the strategy that has been followed by Kerala.

41. **Local governments should have power to hire, fire and determine the compensation level for their employees.** Without this discretion, it is difficult to see how local governments can control their budgets and be held to a hard budget constraint. Moreover, this would eliminate the dual responsibility that conflicts local government employees between accountability to the government unit for whom they work, and accountability to the level of government that determines their well-being in the workplace. Effective implementation of service delivery by rural local governments would seem to require accountability of their officers.

42. **At the same time, it is important to ensure clarity in the role of line agencies.** These agencies today implement schemes for the state, district, block and village panchayats. This undermines accountability. Moreover with fiscal decentralization the roles of state line agencies for functions devolved to panchayats needs to change accordingly.

C. Augment Panchayat Resources

43. **Augment gram panchayat resources.** While the gram panchayats have the constitutional mandate to perform the role of local self governments, they do not have enough discretionary resources to do so in a meaningful way. In Karnataka, total revenues available to gram panchayats from all sources are Rs. 68 per capita (less than 0.4 percent of gross state product). The result is that the impact of the local budgets is too small to attract the attention of the local population, and the goals of better accountability and more involvement of citizens in governance are not reached. Kerala is in somewhat better shape with per capita spending of Rs. 328 (1.4 percent of gross state product), but even this amount is not likely to stimulate great local interest in budget priorities and outcomes. Therefore, a key priority in both states is to augment gram panchayat resources. There are many ways to do this.

44. **In Karnataka, consolidate some of the schemes into untied funds for gram panchayats.** This consolidation should include state and central schemes as well as centrally sponsored schemes. To the extent this could include a redirection of some funds away from districts and blocks, it would augment the revenues of gram panchayats.

45. **Increase own revenues of gram panchayats.** Reforming the tax system and user charges levied by the GPs is one of the most important elements of the fiscal decentralization reform. Revenue performance is very weak in both states. The problem is not primarily the absence of revenue sources, or the absence of discretion to increase revenues. In fact, the results for both Karnataka and Kerala show a wide variation in per capita revenue, with some GPs performing better than others even under equivalent fiscal capacities. Moreover, both Karnataka’s and Kerala’s empirical results reject the hypothesis that grants reduce the revenue collection of local bodies. The problem seems to be an unwillingness of the GP to enforce the taxes available to them or even to levy the maximum allowable tax rates. While this is not the case for every GP, it is the case for many local governments in both states. The underlying problems
that lead to a low revenue productivity have to do with an inadequate tax structure, a weak tax administration and perhaps with the disconnect between higher taxes and what voters see as the benefits of higher taxes. A number of reform options discussed below might be considered to address these problems.

46. **Improve the structure of the property tax.** At present, revenue collections are low and inadequate to cover even the cost of basic local public services. In Kerala, flaws in the design of the property tax system have prevented Panchayats from benefiting from the real estate boom taking place in that state, or from significant foreign remittances. In Karnataka, the growth in property values in more prosperous areas has not been captured. A major problem in both states is the present system of valuation. Houses are valued at their estimated rental value, and this amount is not changed frequently. The values are set rather than being based on some scientific approach. The move to a more systematic system of valuation, even if very basic, and regular revaluation, would significantly increase the revenue yield of the property tax in both states. (Box 2). How to do this? One approach, already used in Bangalore, is to fix value against location, area and construction materials of structure to develop a simple system of determining area-based values. This is not a perfect system for valuing, but it can be used to increase the size of the property tax base in an approximate fair manner\(^\text{11}\).

47. **Improve collection of the property tax.** The Gram Panchayats do not collect even the low amounts of taxes that are levied. Analysts in both states see the property tax as more voluntary than mandatory, and place the blame on a weak enforcement system. The state governments may take the lead here by helping to improve the capacity of GP tax administration personnel, providing technical assistance to improve property tax administration systems, increasing the penalty rate for non-payment, and providing incentives for increased collection efficiency. A first step might be to provide technical assistance to local governments to do a complete update of their tax rolls, and to enhance the capacity of local officers to maintain this roll.

48. **Improve collection of user fees and charges.** The Karnataka and Kerala case studies show that non-tax revenues (user charges, rents, licenses and fees) are as large in amount as tax revenues and in some cases are growing faster. This may signal an enhanced ability to collect revenues when a direct linkage to a service is present. However, in both states there is a wide variation in the use of non-tax revenues. This is due to some combination of different opportunities, different willingness to levy such charges, and differences in the capacity of the local tax administrations to put such a system in place. The two states could provide a technical assistance program to organize the assessment and collection of user charges, and it could facilitate the transfer of information among the thousands of GPs involved. If an incentive program is offered to encourage increased local government revenue mobilization, it is important that it include non-tax as well as tax revenue.

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\(^{11}\) Another approach, while not the best approach, is that states could increase property tax revenues by simply charging the maximum rates available.
Box 2: Local Property Taxation

Most local governments in developing and developed countries are given the right to tax property, and most use this power. International “expert” opinion generally holds that this is a “good” tax for local governments. We may also note that most local governments in developing countries are fiscally strapped. They are usually assigned few tax bases, and they often are unable to effectively administer those taxes that they are given. This seems especially true for the property tax. So, casual observation would suggest that the “good” local tax is not getting the job done.

There are significant advantages to the property tax. The property tax can be revenue productive, and is often the mainstay of local government fiscal systems. It accounts for about 0.4 percent of GDP in developing countries, a share well below that in industrialized countries. While this may seem a small amount, it should be pointed out that it is large enough to finance about 11 percent of sub-national government spending.

Some have argued that there is fairness in the property tax in that property values, and therefore property taxes, rise with the provision of better local services to the property. There would seem to be fairness in asking the benefiting property owners to pay for these services. The property tax is most probably not regressive, and may vary from proportional to progressive. In an ability-to-pay sense, it could be viewed as equitable. A significant portion of the residential property tax, and some of the non-residential tax, is borne by landowners who usually sit atop the income distribution. Many of the poor are screened out of the tax, by explicit exemption of properties of value below a certain amount. Moreover, the property tax captures in its base those who hold wealth but may be missed by the income tax.

Perhaps the biggest disadvantage of the property tax is its unpopularity with local residents and voters. Why is the property tax so unpopular, and why does it draw out such protest? First, it is a very visible tax. Unlike the Value Added Tax (VAT), for example, where no one really knows how much they pay, the property tax is paid annually or in periodic submissions, and the taxpayer is quite clear about his/her liability. Second, assessment is judgmental, unlike sales or income taxes. Taxpayers are uncomfortable with this. Third, the property tax is a levy on accrued income, not on realized income, which seems unfair to many taxpayers. Another major disadvantage is that administration costs are high if the tax is to be well administered. Valuation, done properly, is an expensive proportion, as is effective enforcement.

The major problems with the property tax becoming a significant revenue source for local governments in developing countries are problems related to valuation and enforcement. With respect to the former, most countries just do not have the procedures or staff in place to carry out the job. With respect to the latter, there is some question about the willingness of local officials to enforce such an unpopular tax, especially when the burden often falls most heavily on local elites.

This set of advantages and disadvantages has led countries around the world to use the property tax as a revenue source, to widely varying degrees. Generally, industrialized countries make greater use of the property tax than do developing economies. As noted in the table below, the reported intensity of use of the property tax in India is quite low.

<table>
<thead>
<tr>
<th>Country</th>
<th>Property Tax/GDP</th>
<th>Country</th>
<th>Property Tax/GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Canada</td>
<td>4.07</td>
<td>Indonesia</td>
<td>0.32</td>
</tr>
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49. **Broaden the tax base.** The main problems with revenue performance at the panchayat level are administration, capacity of the tax offices, and willingness to tax. However, there are some possibilities for broadening the tax base that are worth considering as policy reforms. There would seem to be two good options for broadening the tax base. The first is for the states to allow rural local governments to tax agricultural land as part of the property tax regime. While enforcement may be difficult, the revenue potential is significant, and this may be a more appropriate tax base in communities that have a more developed agricultural sector. A second possibility for base broadening is a rudimentary form of business tax. This is used to good effect in Kerala (though it could be strengthened), and could add value to the revenue system of Karnataka’s rural local governments that are more in the nature of “commerce towns.”

50. **The states should appoint a technical assistance team to begin improvement of at least property tax administration.** At a minimum, the focus of this technical assistance could include the development and implementation of statewide standard procedures for valuation and revaluation, maintenance of the tax roll, and training. Some incentives for more intensive use of the property tax also need to be developed.

D. **Redesign Transfers**

51. **Transfers should be determined in a transparent manner.** The state should establish a clear and transparent way in which the aggregate transfers, the relative shares of urban and rural local governments, and the allocations to each of the tiers of urban and rural local governments are determined. This does not happen now in Karnataka. The present allocation evolved historically, based on the expenditures incurred before the schemes were transferred to the local bodies. There has been little attempt to estimate the expenditures needed to carry out the functions assigned to the local governments, hence the determination of the vertical share of panchayats may be significantly flawed.

52. **Unbundle the transfer system from scheme based transfers into broad programs.** The critical element of reform is to unbundle the transfer system from scheme-based transfers into broad programs and impart flexibility and autonomy for the local governments to make allocations according to their priorities. This is particularly so for the gram panchayats, which, as discussed above, is perhaps the only meaningful tier of local government. If states choose to maintain districts and blocks as essentially deconcentrated arms of higher-level governments, even here, consolidating schemes and increasing flexibility would go a long way towards reducing administrative burden and improve expenditure efficiency. In Kerala, significant strides have already been made in this area by converting many of the schemes into untied grants and giving significant budgetary discretion to especially the gram panchayats.

53. **Relate transfers to need and capacity.** The distribution of transfers among the gram panchayat governments in Kerala is done on a basis of an objective formula that contains some elements that suggest equalization. In Karnataka, by contrast, the allocation among gram panchayats for untied grants is done on a basis of “equal” total amounts, that is, the same rupee amount to each GP irrespective of population size or composition, economic structure, level of development, location, and so on. As such, it does not take into account either the capacity to raise revenues or expenditure needs (and poverty) of the GPs. While it is necessary that the transfer system should be simple, it should not ignore the equalization principle altogether. We can note from the quantitative analysis carried out in Karnataka, that even when tied grants are considered, there is no relationship between the distribution of these grants and the concentration of scheduled castes and tribes in the GP population. A high priority reform is for the Karnataka system to be changed to reflect whatever degree of equalization the government desires with respect to fiscal capacity, or expenditure needs. In view of the great advance Kerala made in measuring poverty at the GP level, the question of refining and using the poverty index as a criterion may also have to be examined. (Box 3).
Box 3: Allocating Transfers By Formula

Many countries that are decentralized and many of those that are deepening their fiscal decentralization, distribute intergovernmental transfers by formula. A formula is transparent and objective, and once established, does not change regularly. However, an effective formula-based distribution of transfer requires up-to-date and reliable information on the formula elements. The smaller the recipient unit of government, the more difficult it is to identify a formula. While the use of formulae have been fairly widespread for distribution from central to state governments, the practice is much newer for state-local revenue sharing and is much more constrained by data limitations.

Some governments in transition and developing countries do use formulae to allocate grants to the bottom tier local governments. In some cases the formulae are more complex, and in some cases a significant amount of judgment is required in developing the indicators to be used. An interesting example is the “equitable shares” grant in South Africa, which is an unconditional central government grant to urban and rural local governments. It is distributed according to (a) the number of poor households in the municipality (that is, those spending less than a “threshold” amount), and (b) the cost of delivering a standard level of basic services to a household (electricity, water, sanitation and refuse removal). The central government sets both the poverty threshold and the cost for basic services. Both are determined as uniform national amounts.

Indonesia introduced a big-bang fiscal decentralization in 2001, with the centerpiece being a formula grant system. The central government distributions of this grant were made directly to the lowest level local governments. The formula elements are population size, poverty rate, land area, and the construction price index. The weights on each of these formula components have changed, depending on political and economic considerations. Population and land area were given larger weights in the 2002 distribution.

Many countries with three levels of government distribute grants to the lowest tier using a variety of formula methods. Generally, there are many different grant programs in a single country, and these are distributed among local governments in many different ways. Among the objective (and subjective) indicators that countries have used for distribution to local governments are population size and poverty (Mexico), the value of real estate (Brazil), the balance between expenditure needs and fiscal capacity (Russia and China), and equal shares (India).

54. The States should obey their own rules. A major problem in both Karnataka and Kerala is that the state governments do not pass full transfer entitlements to their local governments. In effect, state deficits are being passed down. This practice eliminates transparency, discourages the objective of decentralization and moves the system of intergovernmental fiscal relations toward a yearly ad hoc arrangement. The state should budget for that level of transfers that it can make, and distribute the full amount in a timely way.

55. Make transfers predictable. Due to the system of funds flow, multiplicity of accounts, many accounting centers, and antiquated recording of information, no one is sure about how much money actually flows to the panchayats. The timing of this flow, with “bunching” at the end of the fiscal year, and the failure of the treasury to release full entitlements, subjects local fiscal planning to great uncertainties. This situation undermines any attempt at planning or budgeting at the panchayat level, and confounds attempts to monitor the fiscal performance of local governments. Reducing the uncertainty in the transfer system would go a long way towards improving fiscal management at the Panchayat level. And this can be achieved easily through states transferring panchayat entitlements on agreed upon dates and amounts.

56. Determine the vertical share of rural local governments objectively. An objective determination of the vertical share of rural local governments (the entitlement of the local government sector in the state budget) should be established and held to. There are several choices for the determination of this vertical share, but an ad hoc, annual determination is least consistent with the goals of fiscal decentralization and improved responsibility and accountability of local governments (Box 4).
A crucial feature of the design of intergovernmental transfers is the determination of the vertical shares, that is, the entitlement of the rural local government sector. It is important that this be transparent, so as to encourage efficient fiscal planning by local governments and to make possible the imposition of hard budget constraint on them. In theory, in an equalizing grant system, the vertical share is the amount necessary to fund that part of minimum expenditure needs that local fiscal capacity cannot fund. In practice, such a calculation is rarely made.

Generally, countries use three methods to establish the vertical share entitlement. The first is an ad-hoc arrangement. Each year, or for a period of years, the higher-level government decides on the amount of the entitlement. This gives the higher level government maximum discretion in adjusting the vertical share to fit the exigencies of the current budget situation. A variant of this is to appoint a commission that makes or recommends a decision on allocation for a period of years, such as is done in India and Australia.

The second approach is to fix the vertical share as a percent of revenues of the higher-level government. This is perhaps the most transparent of the approaches, and (if the higher-level government follows through on its commitment under this approach) gives the local governments a guarantee of resources to be received. Indonesia allocated 25 percent of internal taxes to the revenue sharing pool for local level governments, and the Philippines allocates more than one-third of total internal central revenue collections, lagged by two years. China, Russia, Mexico, Argentina and Brazil are countries that dedicate percents of their income tax and VAT revenues to the revenue sharing pool. Many countries mandate that a percent of the funds distributed to provinces or states be passed through to municipalities (Nigeria, Mexico and Brazil, for example).

The third approach is more in the vein of cost reimbursement. The higher level government determines those functions of local governments that it will support financially, and provides conditional grants that are determined in amount by the higher level government. Grants by states to local government in much of India ("schemes") are of this type. The most common functions that are singled out for conditional grants are basic infrastructure projects, teacher’s salaries, and welfare-health related outlays. Virtually every country in the world has some form of conditional grants in its system of intergovernmental transfers.

Which is the better way of vertical sharing? It depends on the objectives that the government most wants to achieve with its system of intergovernmental transfers. A guaranteed share of revenues will probably give the local governments the most predictable revenue stream, and the most insulation from the political impacts on budget-making by the higher-level government. While this would seem to be the approach most consistent with fiscal decentralization, it has the drawback of limiting the fiscal flexibility of the higher-level government.

57. Relate transfers to state revenues, not to state outlays. The present approach to vertical sharing calls for some re-thinking. If the entitlement of local government is largely linked to plan size, then it will vary from year to year depending, in part, on expenditure choices made by higher-level governments. If it is linked to total state revenues, it will be subject to the fluctuations in state receipts. The better route, and perhaps the more transparent and less politically-driven approach might be to base the vertical share of local governments on total state revenues rather than on planned expenditures. This share could be changed periodically by the SFC.

58. Institute an incentive for increased revenue mobilization. The transfer system could be amended to provide an incentive for increased revenue mobilization. While this will be difficult to design and monitor, it might be a useful way to stimulate GPs to increase their tax effort. A special pool of funds might be set aside for distribution among those local governments that reach a certain tax collection plateau set out by the state government, or even to those that implement certain desirable features in their tax administration system. This will almost certainly not be an equalizing feature of the intergovernmental fiscal system, but it could encourage increased revenue raising efforts.
Box 5: Problems in Redesigning the Transfer System: the Kerala Example

The design of a transfer system is difficult, especially if the subjects are rural local governments. First, the quality of the data to be used in the distribution formula may be suspect, or the information may be dated. For Kerala, several indicators of service needs and fiscal capacity are available, but for many of these indicators, the data is missing for a significant number of GPs. These indicators would have to be eliminated as possible candidates for inclusion in the formula, or the data set will need to be improved. The situation is no better in the case of measuring taxable capacity. There is no data on personal income or economic output at the GP level. Some data on housing might be gathered regularly (for example, number of housing units of various types) and could be suitable for measuring property tax capacity. However, gathering such data could be a costly proposition.

Measuring poverty is problematic. Official poverty rate indicators are not available at the GP level. Ideally, the state will allocate its resources more heavily to those GPs where the concentration of poor families is greatest. The measure used in this study, the percent of population in scheduled castes and tribes, is imperfect at best. Yet it is poverty as much as any indicator that the state would like to factor into its distribution formulae. A second constraint is that an equalization formula may allocate significantly more funds to smaller, poorer gram panchayats. Will these local governments have the capacity to effectively use the additional funds?

A third constraint to grant reform is that any new formula will result in both “winners” and “losers.” That is, some GPs will receive more than under the previous system, and some will receive less. Those who lose will object, probably strenuously, and will point out that at a minimum, there is need for an adjustment period. The result is that any new formula will need to be phased in over a period of time in order to protect the losers from a “shock effect.” There are many ways to design a hold-harmless system, but an essential ingredient must be that the phase-in period has a clearly defined end point. In order to identify the extent of this constraint, we need to know how much the present system of distribution would be “shocked” by the introduction of a new system. The greater the shock, the more complicated the design of the hold-harmless system.

A fourth constraint is that related to building an intergovernmental transfer system. The system feature implies that all the components (grants, statutory grants, and so on.) fit together to achieve the same objectives. The easiest way to do this is to merge all transfers into one unified grant system. However, some will argue for more than one component and more than one objective, and this will raise the possibility of offsetting effects (for example, component A will be equalizing while component B will be counter equalizing, and so on).

What this discussion points to is the need for the State to begin with some realistic decisions about the objectives it wants to achieve with its intergovernmental transfer system. In fact, there is no one best system, and everything depends on the goals that are laid down.

The study examined some options for the design of an optimal transfer system for Kerala (details in Volume IV). Below is a recommended transfer formula. From the simulations carried out there is much to recommend a per capita consolidated grant. It is simple and transparent and a straight population allocation recognizes needs and can be calculated with a minimum of arbitrariness. The data is more available than for other allocation schemes. The “shock” of transition to the consolidated per capita grant from the present system would not be so great. There would be about as many GPs that gain as would lose, and the average increase for a “winner” would be 14 percent while the average reduction for a “loser” would be 13 percent. Only one GP would gain more than 50 percent on a per capita basis, and only six would lose more than 50 percent. A kind of ‘hold-harmless’ system to protect such outliers could be easily devised. There are also disadvantages to the per capita consolidated grant. The one shortcoming that most will call out is the failure of such a system to recognize the special needs of places that are poor, or that must serve large land areas. Moreover, there is no provision for rewarding those GPs that make a greater tax effort.

59. Strengthen State Finance Commissions. There is no question that the State Finance Commissions can make a major contribution towards strengthening intergovernmental fiscal relations. In Karnataka, however, the SFCs have not been as successful as one would have hoped. There are a number of reasons why: an unwillingness of the state to accept the recommendations of the Commissions, the absence of staff to support the work of the SFCs, and the absence of complete and accurate fiscal data on which to base the analysis. Moreover, it is not clear that the state government has a cell that regularly tracks the
performance of the local governments. While Kerala appears to have developed a system of intergovernmental fiscal relations that is more suited to decentralization, it is not clear that they are any better off in terms of having a supporting analytical cell or a usable fiscal information system for rural local governments. The following are steps that the states should take in redressing these problems. First, establish an analytic cell within each state that is charged with tracking the performance of the local governments. This cell could serve as staff to the SFCs at the time of the work of the SFCs. Second, develop and maintain a census of local government finances, based on a uniform set of local government accounts. Third, produce an annual report on intergovernmental fiscal relations that describes and evaluates local government fiscal performance.

E. Improve Accounts and Accountability

60. Local governments should prepare budgets and financial accounts. This implies a number of prerequisites: staff with a capacity to do the job, certainty of revenue flow from the state level, and an accounting system that will enable a tracking of budget implementation. At the close of the fiscal year, all panchayats should prepare financial statements in a common format that reflects standard international practices for local governments.

61. Ensure timely consolidation of accounts. Preparation of monthly accounts and annual accounts should emanate from consolidated receipts and payments or trial balances of ZPs and TPs based on the statements of all drawing officials and not from records of the Treasury. The Treasury should function only as a banker to ZPs and TPs. The closing balance arrived at from the books of accounts of ZPs and TPs should be reconciled on a monthly basis with the figures of the Treasury. The responsibility of preparation of monthly and annual accounts of TPs should be that of TPs and not that of ZPs.

62. Bring in mainstream accounting. The Accountant General’s Office has recommended revised accounting systems and a chart of accounts for PRIs. There is need to bring in mainstream accounting by the introduction of general ledgers, sub-ledgers, and simplification of charts of accounts, including reduction in number of heads of account. Annual accounts should have schedules of various assets and liabilities, and income and expenditure including a list of properties and fixed assets owned by PRIs, and so on. Also there is a need for schedules for other major accounts like loans, deposits and so forth. It is preferable to have sub-ledgers or subsidiary ledgers for the suppliers and contractors accounts. This will enable the PRIs to effectively monitor and administer the individual contracts.

63. Overhaul the accounting and the budgeting system of the PRIs. Serious thought may be given to introduce a modified double entry system of accounting. The accounting system and the manner of presentation of the budget should be redesigned in such a manner that appropriate financial reporting is made possible for various purposes, such as on-going monitoring, performance evaluation or cost of providing individual services. For keeping up-to-date accounts and for ensuring transparency, it is necessary to computerize the book keeping function of panchayats.

64. Redesign the internal management structure of Gram panchayats. As the president is executing many executive functions, it is necessary that he shares the responsibility associated with such functions. Considering the volume of work in gram panchayats, it seems necessary to introduce a kind of cabinet system of functioning with the president and the chairpersons of the standing committees forming a team. The line of control of the panchayat bureaucracy, especially that of those from the transferred departments, should be made unambiguous.

65. Improve auditing. All efforts should be made to bring the statutory audits up-to-date. The accounts of the majority of PRIs have not been finalized for years. The final accounts should be in place within two months after the close of the financial year. Ideally, the audit should be done within six months thereafter. The Performance Audit Authority needs to carry out its two roles: one, to act as the internal auditor of panchayats; two, to evaluate the performance of the panchayats and to provide them with
suitable advice for improvement. The time has come to introduce value-for-money audit for the local
government institutions, so that they may be made accountable not only for observing rules and norms,
but also for results.

66. **Provide positive incentives for mechanisms for downward and upward accountability.**
International experience shows that, to have viable local governments, and a positive impact on service
delivery, people’s empowerment and community development is important. Both states have a legislation
supporting this approach. For example, right to information, overseeing functions of the Village
Assembly (gram sabha), social audit, transparent method of beneficiary selection, social mobilization,
citizen’s charter etc. and implementation of these functions should be taken into consideration in
evaluating the performance of the panchayats. This seems to be the right direction forward for mutually
reinforcing approaches of service delivery mechanisms through local governments and community
participation.

F. **Create an Information System on Local Finances**

67. **It is crucial to compile a census of government finances for the panchayats.** Building and
maintaining a reliable information system is key to designing and implementing an efficient
intergovernmental fiscal system. As this study has shown, it is possible to develop a reasonable set of
fiscal statistics that more or less portray the fiscal condition of local governments. These efforts will have
to be made regular and systematic to develop a robust data bank on rural fiscal decentralization in the
state. While the effort to maintain a data base might begin with the present system, and follow the steps
taken in this study, it will be necessary in the long run to move towards a standardized set of local
government financial accounts. This will require developing the capacity, particularly at the level of GPs,
to collect and report the proper information. This is a high priority need of the states. Such an
information system will take time to develop, but without it fiscal decentralization cannot be managed.

VI. **CONCLUSION**

68. **This study focused on Karnataka and Kerala because these states are perceived to be ahead on rural decentralization.** However, even in these states, and even 10 years after the Constitutional
Amendment, the agenda and implementation plan for rural local government finance is not clear.
Karnataka has burdened the district and the block levels with state personnel and earmarked the use of
resources such that elected governments are treated as service agents. The tier closest to the people, the
gram panchayat, has been left with hardly any resources and very little expenditure discretion. Kerala, on
the other hand has arguably a better designed and more mature decentralization system, but is captive to
the fiscal situation of the state government, and the result is again under-funding of the decentralization
initiative relative to its entitlements. Other states would appear to share several of the problems outlined
above, consequently it is plausible that many of this study’s conclusions and recommendations should
apply across India.

69. **The fiscal decentralization system is flawed.** The study concludes that despite India’s commitment
to rural decentralization, panchayats cannot live up to their potential because the structure of the fiscal
decentralization system is flawed. While Karnataka continues to make efforts on moving ahead on this
policy agenda, what is in place today is a patchwork of legislation and measures that reflect what has been
politically and bureaucratically possible. While many initiatives have tried to move the agenda forward,
they were pursued in a fragmented and narrow way. In Kerala the system is better structured to achieve
the goals of fiscal decentralization, particularly because it gives more expenditure autonomy to gram
panchayats, but it is still flawed in important ways.
70. **The State Finance Commissions, and newly formed cells within the Finance Department, could make an important contribution.** In both states, they could lead the development of a policy plan that spells out the goals for decentralization, the policy and legislative agenda, an implementation plan, a schedule of technical assistance for rural local governments, and a timetable. This could serve as the much needed blueprint for fiscal decentralization.

71. **Official data on finances is not reliable.** It is difficult for the data contained in local financial records to tell a transparent story on local financial performance. First, official records of panchayat revenues are based on budgeted allocations rather than cash received; second, the significant irregularity in the timing of transfers and their amount distorts both actual expenditure patterns and the reporting of these expenditures; and, third, weaknesses in record keeping systems and practices are prevalent. Data on revenues and expenditures are published regularly and are used to make policy prescriptions, namely by the Central Finance Commissions and the State Finance Commissions. But this data is badly flawed, and inflates the funds actually managed by panchayats considerably. In fact, neither panchayats, nor SFCs, nor GoI, nor state Rural Development and Panchayat Departments know the actual amount of funds available to panchayats, or the expenditure patterns of panchayats. Gathering the data necessary to obtain an accurate picture of the finances of rural local governments was, of necessity, an important objective of this study.

72. **Rural decentralization is far from complete.** The rural local governments for the most part do not have adequate capacity to deliver services, collect taxes, or keep track of their financial affairs. The state governments are not yet up to implementing the intergovernmental system, or to a full tracking and monitoring of the financial performance of their local governments. The central government still plays a role in sub-state fiscal relations, and this both helps and confounds the problems. On top of this, the overall government deficit limits how much can be done by way of devolving resources. All of these factors suggest that it is a time for planning the development of the finances of the rural local sector, and that there is a premium on capacity building at the state and the local levels. The progress in fiscal decentralization to the rural government sector can produce quite remarkable results.

73. **In fact, fiscal decentralization is a process that needs to be followed in a programmatic manner.** There are some guidelines that might be used to structure such a program, as indicated by the following sequence of reform options.

- Develop a fiscal decentralization plan that includes all of the necessary components, and is based on the objectives which the government has set.
- Begin investing in upgrading the capacity of the state government to lead and monitor the reform program and in the capacity of the local governments to implement the reform.
- Clarify expenditure assignments
- Improve local government revenue mobilization through structural reform and improved implementation.
- Restructure the transfer system to realize equalization objectives, and to allow local governments more autonomy and discretion in the use of funds according to their own priority setting and planning mechanism, jointly with improving local government capacity.
- Fix the financial reporting system of local governments.
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